



Understanding Tax-Managed Funds

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Mutual funds have gotten a bad reputation over the years. When they do poorly, investors complain that they're losing money. When they do well, however, they tend to make large distributions of capital gains to their shareholders, driving up the shareholders' tax bills and making them unhappy. Some investors have gotten so fed up with big capital gains distributions that they've given up entirely on mutual funds, moving instead to exchange-traded funds that generally give them more flexibility to realize their capital gains when they want.

However, mutual funds are far from giving up just because of a few tax problems. Instead, some fund companies have gotten on the tax bandwagon by introducing tax-managed mutual funds, which promise to keep capital gains distributions low by using a variety of techniques. With the gains in the stock market over the past five years, tax management is likely to become increasingly important in determining total returns for investors.

Why taxes are a problem

The way that mutual funds have to deal with taxes is confusing to many investors who are more familiar with trading individual stocks. With stocks, you have almost complete control over when you pay tax on your capital gains. If you decide to sell a stock, then you'll pay tax on any capital gains you have; if you hold on to the stock, then you don't have to pay tax no matter how high the price goes.

With mutual funds, however, there are two things that create tax liability for fund shareholders. If you decide to sell the shares of your mutual fund, then you'll pay capital gains tax just as you would on an individual stock. Yet you might also have to pay tax even if you hold onto your shares. If your mutual fund sells some of its portfolio holdings that have risen in value since the fund bought them, then the fund will have capital gains. Because of the way the tax laws treat mutual funds, the fund must then distribute out that capital gains liability to its shareholders -- even if the overall value of the fund dropped during that year.

The losses in most stocks between 2000 and 2002 gave many mutual funds a reserve of capital losses that they have carried forward over the intervening years to offset subsequent gains. As the bull market progresses, however, most funds will eventually use up all of these losses, and shareholders will again begin to see a substantial flow of taxable distributions as a result. Perhaps the most obvious example is the **Fidelity Magellan Fund** (FUND: [FMAGX](#)), which made a huge distribution equal to 18% of its entire value last June as a result of selling longtime holdings like **Intel** (Nasdaq: [INTC](#)) in favor of newer companies like **Google** (Nasdaq: [GOOG](#)) and **Nokia** (NYSE: [NOK](#)).

How funds manage taxes

There are a number of methods that mutual funds can use to manage their taxes. The simplest is to try to minimize portfolio turnover, which is the amount of buying and selling that the fund does over a given period of time. Another method that some fund managers use is to try to find stocks that have lost money and sell them to offset the gains from stocks that have made money. While this method can reduce capital gains substantially, funds that perform well will eventually use up any losses and still have plenty of gains left to create tax liability for their shareholders.

Other methods for managing capital gains involve things like having the fund make purchases of portfolio holdings in multiple lots, giving the fund manager the option of identifying the shares that have the least capital gains associated with them and thereby minimizing the total amount of gains the fund must pass through to its shareholders. In addition, some funds impose fees on shareholders who sell fund shares, because the need for liquidity to pay exiting shareholders is one of the reasons why funds have to sell the stocks in their portfolios.

How important are taxes?

Taxes can have a big impact on your overall portfolio returns. Funds that have high portfolio turnover and generate substantial amounts of capital gains liability, especially with short-term capital gains distributions, have to increase their pre-tax returns in order to keep up with other funds that have lower turnover and avoid capital gains. Looking at Magellan's performance information, its pre-tax return during 2006 was 7.22%, but after considering taxes on its distributions, the after-tax return was only 3.67%.

On the other hand, taxes shouldn't be the primary factor in choosing a mutual fund. After all, the main reason why you choose to have a money manager actively overseeing your fund's portfolio is to make good decisions about when to buy and sell stocks. If your manager believes that one of the fund's holdings is going to fall in price, you want the manager to feel comfortable dumping that stock without necessarily worrying too much about the tax impact. As many investors have learned the hard way, it's much better to pay taxes on gains than not to have any gains at all.

Nevertheless, tax management is an issue that all fund managers should address, not just those with "tax-managed" in their names. Many of the methods that mutual funds can use to minimize the amount of tax liability they generate don't restrict their ability to make portfolio decisions that are in the best interest of their shareholders. By looking both at pre-tax and after-tax performance, you can make sure that your fund is watching out for your bottom line.

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